View metadata, citation and similar papers at core.ac.uk

brought to you by CORE

provided by UND Scholarly Commons (University of North Dakota)

North Dakota Law Review

Volume 49 | Number 1

Article 4

1972

Where Subchapter S Leaves Off the Limited Partnership Begins

Garry A. Pearson

Follow this and additional works at: https://commons.und.edu/ndlr

Part of the Law Commons

Recommended Citation

Pearson, Garry A. (1972) "Where Subchapter S Leaves Off the Limited Partnership Begins," *North Dakota Law Review*: Vol. 49 : No. 1 , Article 4.
Available at: https://commons.und.edu/ndlr/vol49/iss1/4

This Article is brought to you for free and open access by the School of Law at UND Scholarly Commons. It has been accepted for inclusion in North Dakota Law Review by an authorized editor of UND Scholarly Commons. For more information, please contact und.commons@library.und.edu.

WHERE SUBCHAPTER "S" LEAVES OFF THE LIMITED PARTNERSHIP BEGINS

GARRY A. PEARSON*

It is not only the Phoenix which rises from the ashes. Recently an ancient but little known vehicle for doing business has received considerable popularity due to the innovativeness of modern tax counsel. This entity is the limited partnership which, although it dates from the middle ages,[1] became practicable only in 1916 with the promulgation of the *Uniform Limited Partnership Act*[2] and then was resurrected as a modern means of doing business. It has been a rare bird, but because it uniquely accomplishes certain tax results, it is often found today.[3]

North Dakota has adopted the *Uniform Limited Partnership Act*.[4] A limited partnership can have as few as two persons, one of whom must be a general partner with unlimited liability; it can have an unlimited number of limited and general partners.[5] Formation of such a partnership is not difficult and standard form books contain generally reliable samples, which, like all forms, must be tailored to the required shape, which may be standard or peculiar. In addition to the partnership agreement the draftsman prepares a sworn certicicate containing the information required by Sec. 45-10-02 of the *North Dakota Century Code*. This certificate is then filed in the Office of the Clerk of District Court in the County where the

---

* B.S., B.A. 1956, J.D. 1958, University of North Dakota; Certified Public Accountant, 1957; Trial Attorney, Tax Division, United States Department of Justice, 1958-1961; Lecturer in Taxation, University of North Dakota School of Law; Garry Pearson, Ltd., Grand Forks, North Dakota.

1. 68 C.J.S. PARTNERSHIP § 449(c) (1950).
2. 42 ABA Reports 349 (1917); 6 U.L.A. 559 (Master Ed. 1969).
3. Dear Mr. Pearson: In reply to your letter dated September 15, regarding limited partnerships filed in our office to date, from the year 1959 through 1966 there were 21 such partnerships filed with us. From 1967 through today there have been 59 such filings. The years 1968, 1971 and 1972 have been the years with the largest number of filings; 11, 16 and 11 respectively. I hope this information is of value to you in your article for the North Dakota Law Review.

Letter from Ben Meier, Secretary of State to Garry Pearson, Sept. 20, 1972, on file in the office of the *North Dakota Law Review*.

4. N.D. CENT. CODE ch. 45-10 (1960).
5. N.D. CENT. CODE § 45-10-01 (1960).

partnership is located and a second certified copy is filed with the Secretary of State.

Although the general partner has unlimited liability, the limited partner risks only the contribution he has made to the firm.[6] In this sense, the limited partner enjoys the same protection enjoyed by stockholders in a business corporation, without giving up much to obtain such favorable treatment. It is only necessary that his name not appear in the name of the limited partnership[7] unless it is also the surname of a general partner or if his name had been used prior to the time he became a limited partner. Nor may he take an active part in the control of the business.[8] Interestingly, one may be both a limited and general partner simultaneously although it is difficult to see what advantage such an arrangement might have since a general partner is liable to creditors to the total extent of his assets for the debts of the firm.[9] Of course he could receive some protection in allocations between himself and his fellow partners.

It is becoming increasingly common to form a limited partnership consisting of individuals as the limited partners and a corporation as the sole general partner. The extent to which the limited partners may take part in the management of the business as the corporation's officers, directors or agents is not known but it would seem the question should be governed by fundamental concepts of corporate law. It is doubtful whether the courts would pierce the corporate veil so long as care was taken to create a viable, active corporation.

Unless you are concerned with the tax considerations discussed hereafter, it is unlikely that you would utilize the limited partnership, as there are few, if any, advantages over traditional business entities. If limitation of liability is important, it is as simple to form a corporation since all investors will enjoy limited liability. If limited liability is not important, but partnership tax treatment is, it is best to simply form a normal partnership.

In 1958 Congress added another hybrid, the so-called Small Business or Subchapter S Corporation.[10] Simply put, the income or losses of such a corporation are taxed directly to the shareholders rather than to the corporation.[11] The organization that is expected to develop losses in the early years of existence, especially one

6. N.D. CENT. CODE § 45-10-07 (1960).
7. N.D. CENT. CODE § 45-10-05 (1960).
8. N.D. CENT. CODE § 45-10-07 (1960).
9. N.D. CENT. CODE § 45-10-12 (1960).
10. INT. REV. CODE OF 1954, § 1371-79.
11. To qualify, the corporation must have no more than 10 stockholders, or a non-individual shareholder (except an estate), or a nonresident shareholder, or more than one class of stock. *Id.*

with heavily financed capital investments in depreciable property with extensive interest payments are quite often incorporated and "Subchapter S" treatment is elected. By this technique the stockholders may deduct any losses during the initial unprofitable years as well as obtain the investment credit on qualified property.[12]

Unless Subchapter S treatment is available and such losses can be passed through to investors, the losses will often be wasted in the traditional corporation although the corporation may be entitled to net operating losses which can be carried forward for five years.[13] But even the net operating loss may be wasted, e.g., it is common for shopping centers to remain unprofitable, at least in the tax sense, for five to seven years and apartment house complexes have about the same gestation period. Moreover, the loss may be more beneficial when deducted at the individual's marginal effective tax rate (up to 70 per cent) than at the corporation's (25-48 per cent).[14] Of course the invester who forms a normal partnership can deduct losses but he is threatened with unlilmited liability to the creditors of the firm.

More important, however, the Subchapter S Corporation has a serious disadvantage. It cannot receive more than 20 per cent of its gross income from so-called passive sources, and the receipt of at least that percentage of gross income in the form of dividends, rents, interest, royalties, etc. will disqualify a Subchapter S Corporation.[15]

Accordingly, the only device that allows limited liability while simultaneously passing tax benefits through to investors is the limited partnership. Although the general partner has unlimited liability, this exposure can be avoided by forming a corporation to serve in the liability capacity, thereby isolating the creditors from the investor's personal assets.

It seems clear that North Dakota law permits a corporation to serve as the sole general partner. Sec. 45-10-01, *North Dakota Century Code* provides:

> 45-10-01. "Limited partnership" defined.—A limited partnership is a partnership formed by two or more persons under the provisions of section 45-10-02, having as members one or more general partners and one or more limited partners. The limited partners as such shall not be bound by the obligations of the partnership.

---

12. INT. REV. CODE OF 1954, § 38.
13. INT. REV. CODE OF 1954, § 172(b).
14. Congress has authorized double declining balance for residential housing. Depreciation on other real estate may not exceed the allowance available with the 150 per cent declining balance method. INT. REV. CODE OF 1954, § 167(j)(5)(B).
15. INT. REV. CODE OF 1954, § 1372(e)(5).

A "person" is generally defined in Sec. 1-01-28, *North Dakota Century Code* as follows:

> The word "person," except when used by way of contrast, shall include not only a human being, but a body politic or corporate.

Moreover, Sec. 10-19-04 Business Corporation Act, *North Dakota Century Code* provides as follows:

> General Powers.—Each corporation shall have power: . . . (7) To purchase, take, receive, subscribe for, or otherwise acquire . . . interests in . . . partnerships. . . .

The general partner corporation would, in a shopping center or apartment project, receive its gross income from management fees which do not constitute "passive income." Accordingly, it would seem that the corporation could elect to be taxed under Subchapter S. The only difficulty is that the Internal Revenue Service might take the position that the gross rental receipts of the limited partnership are to be imputed to the corporation. As there is no authority on this point, the question of whether the corporation should elect Subchapter S depends upon its share of potential partnership rental income, anticipated management fees and the size of any expected tax loss.

There are two hurdles to the successful use of the limited partnership, both of which the careful planner and draftsman can overcome. The first is the requirement that a partner cannot deduct partnership losses which exceed his adjusted basis in the partnership.[16] Where the partners personally supply most or all the necessary investment capital there is no problem. But the usual real estate, apartment house or shopping center development will rely upon outside financial institutions for a majority of capital. An example is the usual shopping center development where the promoter obtains leases with financially secure retail outlets and the leases are pledged to secure a mortgage for a large share of the funds for construction. Often a bank, savings and loan association, insurance company or other credit institution supplies the great bulk of the financing (secured by the leases and the real estate) and the limited partners invest only a fraction of the total capital. Thus, it is relatively common for the losses generated by accelerated depreciation and interest

16. INT. REV. CODE OF 1954, § 704(d).

to quickly exceed the partners' personal capital investment. Once the partners' basis in his partnership interest is reduced to zero, he will no longer be entitled to deduct further losses.[17]

The problem is easily avoided, however, by the Treasury Regulations. A general partner may add to his basis loans made to the partnership for which he is *personally liable*.[18] Because the limited partner has no personal liability, he may not add his share of loans to his basis. But strangely, and fortunately, where *none* of the partners have any personal liability on a loan to the partnership, *all* of the partners, including the limited partners, are considered as sharing in loans, and increased basis, in the same proportion as they share the profits. The Regulation provides:

> (e) Partner's share of partnership liabilities—A partner's share of partnership liabilities shall be determined in accordance with his ratio for sharing losses under the partnership agreement. In the case of a limited partnership, a limited partner's share of partnership liabilities shall not exceed the difference between his actual contribution credited to him by the partnership and the total contribution which he is obligated to make under the limited partnership agreement. However, where none of the partners have any personal liability with respect to a partnership liability (as in the case of a mortgage on real estate acquired by the partnership without the assumption by the partnership or any of the partners of any liability on the mortgage), then (sic) all partners, including limited partners, shall be considered as sharing such liability under section 752(c) in the same proportion as they share the profits.[19]

Thus, limited and general partners are entitled to increase their basis for their partnership interest and their limit on deductible losses by any loans to the partnership on which no partner has personal liability. Obviously, the partnership should seek out loans without personal liability. Logically it would seem that the conventional North Dakota real estate mortgages would qualify because of the great difficulty of obtaining a deficiency judgment.[20] But at least in theory personal liability still exists. However, with the enactment of the Short Term Redemption Act[21] the problem seems solved. Section 32-19.1-07[22] provides:

> No Deficiency Judgment Allowed.—When any mortgage has been foreclosed under this chapter, the mortgagee or

17. *Id.*
18. TREAS. REG. § 1.752-1(a)(2).
19. TREAS. REG. § 1.752-1(e) (1972).
20. N.D. CENT. CODE § 32-19-06 (1967).
21. N.D. CENT. CODE § 32-19.1 (1967).
22. N.D. CENT. CODE § 32-19.1-07 (1967).

any party claiming by, through, or under said mortgagee, shall not be entitled to any judgment for deficiency.

If resort to the Short Term Redemption Act is not possible it is essential that a means be found to eliminate personal liability. A viable alternative is to acquire the lender's permission through negotiation at the time the financing arrangements are being completed.

The second threat to the use of limited partnership is the challenge advanced by the Internal Revenue Service that the firm possesses more of the characteristics of a corporation than a partnership and is accordingly to be taxed like the former.[23] Such a result leads to the loss of depreciation and interest deductions at the individual level, causing the corporation to be taxed on rental income less deductions, and might lead to the taxation of any cash or property distributed to the partners as dividends if there are any earnings and profits. This could be a serious problem because the successful real estate or shopping center development will often generate substantial cash flow and it is the tendency of the investor to recapture his investment as soon as possible.

The Internal Revenue Service's position is reminiscent of that which it assumed and ultimately lost in the professional corporation imbroglio, but here the shoe is on the other foot. Based upon the authority of *Morrissey v. Commissioner*,[24] the Internal Revenue Service advances four characteristics peculiar to corporations, which, if all or a majority are present, leads to corporate tax treatment. Those characteristics are:

1. Continuity of life.
2. Centralized management.
3. Limited liability.
4. Free transferability of interest.

The authorities commenting upon limited partnerships have discussed these characteristics at great length, correctly pointing out that the limited partnerships enjoy to some extent each of these characteristics. It can hardly be argued that limited liability or centralized management are features of such a partnership. But the presence of free transferability of interests and continuity of life depends largely upon the drafter's technique. The Uniform Limited Partnership Act provides that a limited partner's interest

---

23. *See* Giant Auto Parts, Ltd. v. Commissioner, 13 T.C. 307 (1949); Glensder Textile Co. v. Commissioner, 46 BTA 176 (1942); Goll v. Kavanaugh, 29 Am. Fed. Tax R. 1362 (D.C. Mich. 1941).
24. Morrissey v. Commissioner, 296 U.S. 344 (1935).

is assignable but the assignee is not admitted to all the right of the transferor unless all the members consent or the certificate filed with the Clerk of Court and Secretary of State gives the transferor power to confer all of his rights. Otherwise, the transferee's rights are limited.[25] In any event the careful drafter will provide that the limited partner's share is not transferable to any extent without consent if this meets with the basic interests of the syndicate.

The scrivener can again avoid corporate characteristics by carefully drafting his agreements to provide for a lack of continuity of life. The Treasury Regulation provides:[26]

> (b) Continuity of life.—(1) An organization has continuity of life if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will not cause a dissolution of the organization. On the other hand, if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will cause a dissolution of the organization, continuity of life does not exist. If the retirement, death, or insanity of a general partner of a limited partnership causes a dissolution of the partnership, unless the remaining general partners agree to continue the partnership or unless all remaining members agree to continue the partnership, continuity of life does not exist.

In his book, Willis, *On Partnership Taxation*,[27] the author states:

> It is obvious that there is no great difficulty in a limited partnership's avoiding classification as an association taxable as a corporation if the draftsman of the limited partnership agreement, or the tax consultant, studies the regulations and exercises the appropriate professional leadership establishing the parameters of the limited partnership agreement.

A successful real estate development will, of course, earn profits at some time, probably after the passing of the years of heavy depreciation and high interest payments. At this time care should be taken to determine whether the pass-through of income is beneficial to limited and general partners. If it is not (as when the tax rates of the limited partners exceed the effective marginal tax rate at a corporate level) consideration should be given to incorporating the limited partnership with the members exchanging their partnership interest for stock or securities in the new cor-

25. N.D. CENT. CODE § 45-10-09 (1959).
26. TREAS. REG. § 301.7701-2(b)(1).
27. A. WILLIS, ON PARTNERSHIP TAXATION 13 (1971).

poration. A transfer to the new corporation will be tax free[28] and the new corporation will have the same basis in its assets as possessed by the limited partnership. Moreover the limited partners may find incorporation advantageous from the standpoint of ultimately selling their interests to outsiders. Had they sold their partnership interests, the limited partners would be entitled to capital gain treatment on the sale,[29] but gain would, in turn, be subject to recapture of depreciation and recapture of investment credit.[30] Inasmuch as depreciation deductions will likely have been heavy and investment credit taken, the receipts from sale will contain large amounts of ordinary income and increased tax liability. However, if the limited partners incorporate and then sell stock, they will avoid recapture of investment credit and the entire gain will be capital gain. Of course shareholders must be careful to avoid the pitfalls of Sec. 341, *Internal Revenue Code*, 1954, (the collapsible corporations provision). If the limited partnership, now incorporated, is deemed to be collapsible, i.e. formed or availed of principally for the purpose of tax avoidance before a substantial amount of the corporation's income is realized, all gain on the sale would be ordinary income. The simplest method for limited partners—stockholders to eliminate this threat is to hold their stock for at least 3 years after incorporation.[31]

The Internal Revenue Service has taken little note of limited partnerships despite their growing popularity. It has been requested to rule on the *bona fides* of such organizations but its only published commentary is found in a discussion of the conditions under which the Service will consider issuing advance rulings on classifications of organizations. In Administrative Rulings[32] the Service held that the following criteria must be present to obtain a ruling where the limited partnership was formed with a corporation as the sole known partner:

1. The limited partners must not own more than 20 per cent of the corporate general stock (subject to the rules of attribution of Sec. 318).

2. In a limited partnership with a corporate general partner where total capital contributions are less than 2½ million dollars, the net worth of the corporation must be 15 per cent of total contributions or $250,000, whichever is less. For limited partnerships

28. INT. REV. CODE OF 1954, § 351.
29. INT. REV. CODE OF 1954, § 741.
30. INT. REV. CODE OF 1954, §§ 47, 1245, 1250.
31. INT. REV. CODE OF 1954, § 341(b)(3).
32. REV. PROC. 72-13 (1972).

with more than 2.5 million dollars in capital, net worth must be 10 per cent of total contributions.

The balance of the *Revenue Procedures* discusses the methods to be used in determining the requirements above. Even though the organization does not meet these specifications, it does not follow that the Internal Revenue Service will take the position that it is not to be treated as a limited partnership. This is because failure to qualify merely prohibits a ruling by the national office. However, if these directions are illustrative of a position the Internal Revenue Service will maintain in the future, it may be wise to limit the partner's interest in the corporate general manager and adequately finance it.